

CREDIT OPINION

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New Issue

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Honolulu (City & County) Sewer Enter., HI

New Issue - Moody's assigns Aa2 rating to Honolulu, HI's Senior Lien Wastewater Revenue Bonds

Summary Rating Rationale

Moody's Investors Service has assigned a Aa2 rating to the City and County of Honolulu's Wastewater System Revenue Bonds (First Bond Resolution) Senior Series 2016A (\$214M), Senior Series 2016B (Refunding) (\$168M) and Senior Series 2016C (Taxable Refunding) (\$14M).

Moody's has also assigned a Aa3 rating to the City and County of Honolulu's Wastewater System Revenue Bonds (Second Bond Resolution) Junior Series 2016A (Taxable Refunding) (\$25M).

At this time, Moody's affirms the Aa2 rating on the system's approximately \$1.39 billion of outstanding senior lien bonds and the Aa3 rating on the system's approximately \$355 million of outstanding junior lien bonds. The long term ratings carry a stable outlook.

The Aa2 senior lien and Aa3 junior lien ratings are based primarily on the sizable economic base served by the wastewater enterprise, healthy debt service coverage and liquidity, and sound management practices. Also important, the rating incorporates the system's sizable capital improvement plan to address environmental risks which will require substantial borrowing in the coming years.

Credit Strengths

- » Large, established service area; local economy continues to strengthen supported by solid construction activity and tourism
- » A long history of regular, independently-set rate increases that maintain financial stability, support a substantial capital program, and provide healthy debt service coverage
- » Prudent financial policies

Credit Challenges

- » Continued compliance with Consent Decree requires substantial borrowing
- » The overall leverage of the system, although debt service coverage remains sound

Rating Outlook

The outlook for the Honolulu Wastewater System is stable. The enterprise continues to complete projects on time and on budget in order to comply with a 2010 Consent Decree

while maintaining very healthy liquidity and healthy debt service coverage. The stable outlook reflects our view that the system's strong management team will continue to maintain satisfactory debt service coverage and liquidity levels going forward, despite significant future borrowing plans.

Factors that Could Lead to an Upgrade

- » Substantial local economic diversification and improvement in socioeconomic wealth indices
- » Sustained reduction in debt ratio
- » A stronger additional bonds test or other stronger limitations on leveraging the pledged revenues

Factors that Could Lead to a Downgrade

- » Significant leveraging of net revenues above affordable levels
- » Substantial increase in debt ratio
- » Weakened legal provisions

Key Indicators

Honolulu (City & County of) HI Sewer Enter.					
System Characteristics					
Asset Condition (Net Fixed Assets / Annual Depreciation)	45 years				
System Size - O&M (in \$000s)	133,547				
Service Area Wealth: MFI % of US median	131.2%				
Legal Provisions					
Rate Covenant (x)	1.20				
Debt Service Reserve Requirement, current issuance	No DSRF				
Financial Strength					
	2011	2012	2013	2014	2015
Operating Revenue (\$000)	351,906	378,319	362,325	390,468	395,825
O&M (\$000)	115,258	130,076	128,812	132,840	132,911
Long-Term Debt (\$000)	1,710,284	1,882,826	1,997,658	2,003,649	1,957,415
Annual Debt Service Coverage (x)	2.31	2.08	1.73	1.84	1.87
Cash on Hand	1112 days	1147 days	1240 days	1347 days	1481 days
Debt to Operating Revenues (x)	4.9x	5.0x	5.5x	5.1x	4.9x

Source: Moody's Investors Service

Recent Developments

Recent developments are incorporated in the Detailed Rating Considerations

Detailed Rating Consideration

Service Area and System Characteristics:

The system provides wastewater services for approximately 82% of the City and County of Honolulu (general obligation bonds rated Aa1/stable), which encompasses the entire 600 square mile island of Oahu. Honolulu's economy has strengthened somewhat since the

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beginning of the year and we believe the economy will continue to expand steadily in the near term, supported by a combination of healthy visitor volumes from the US mainland, strong construction activity and employment growth in healthcare, hospitality/leisure and professional services. Visitor arrivals remain high and hotel occupancy percentages are also near peak levels. The unemployment rate in Honolulu continues to improve and is near its lowest level in the last ten years: as of April 2016 the City's unemployment rate (2.9%) was just below the state (3.1%) and well below the nation (4.7%). Wealth indicators in Honolulu are favorable with median family income at 131.2% of the U.S.

The customer base is diversified with residential accounts representing the largest by type at 95%. However, only 60% of sewer charge revenues came from residential accounts in FY 2015, compared to 71% in fiscal 2011. The change in revenue composition is largely due to the enterprise shifting to monthly base charge resulting in commercial entities providing a higher proportion of sewer service charges.

The ten largest customers accounted for only 6% of revenues. Despite the large military presence on the island, nearly all bases provide for their own treatment needs. The system operates nine wastewater treatment plants, the largest of which provides 62 MGD of average daily treatment (compared to 94.5 design capacity) and accounts for about 60% of total system flow. Average daily demand of 105.9 MGD in fiscal 2014 represented a manageable 66% of treatment capacity. The city's flow projections are somewhat conservative and reflect an increase through 2020 reaching about 92% of treatment design capacity. As such, after the city addresses collection system projects through 2020, the CIP will shift toward treatment upgrades to secondary from primary in alignment with the 2010 Consent Decree. Nearly all wastewater effluent is discharged into the ocean and biosolids are managed largely through non-agriculture land application or delivered to the city's H-power waste-to-energy facility.

Consent Decree-Related Projects Go Out Through 2030

In late 2010 the city, the EPA, the state Department of Health (DOH), and several non-profit environmental groups reached an agreement on a 2010 Consent Decree. The Consent Decree allows 10 years for completion of work on the collection system, 14 years for the upgrade of the Honouliuli WWTP to secondary treatment, and 25 years, with the possibility of a three-year extension, for the upgrade of the Sand Island WWTP to secondary treatment. From 2017 through 2021 the five year capital improvement program is estimated to cost roughly \$2.7 billion and aligns with the system's twenty year CIP. As mentioned earlier, collection system projects will be the department's top priority through 2020 with treatment projects, including treatment plant replacements and upgrades making up a greater portion of project costs in later years.

In addition to actions taken to date, the wastewater department has developed capital improvement plans covering periods of five, ten and twenty years, in part to comply with prior legal actions. The long-range capital plan will also address safety and public health, permit compliance, system expansion and reliability issues. Over the last five years, a majority of capital funding has come from additional system revenue bonds. Going forward management will gradually shift toward more of an even funding mix of revenue bonds and net revenues. Even with recent issuances, the system's debt ratio has remained around the 2015 level (55%) and including the current new issuance increases only marginally on a pro-forma basis.

Proceeds from the current sale will be used to finance a portion of the system's capital improvement program and refund certain maturities of the system's previously issued bonds for annual debt service savings.

Debt Service Coverage and Liquidity

The system's financial operations are expected to remain sound, supported by proactive management, regular rate increases, as well as debt service and liquidity levels that are guided by formal policies. Senior lien debt service coverage was a solid 3.2 times in fiscal 2015 and revenues are estimated to have increased a solid 15% in 2016 pushing coverage up to 3.5 times. The city attributes the large increase in revenue to rate adjustment, growth in customers and a change in rate structure. Total debt service coverage of senior and junior lien debt in fiscal 2015 was similar to prior year at 2.2 times and is also expected to increase, to 2.5 times. Including reimbursable general obligation bonds and SRF loans, 2015 coverage of all system obligations was 1.9 times. For the current fiscal year (2017) coverage of senior lien bonds is budgeted to decline slightly to a still healthy 3.2 times despite a nearly 8% increase in revenues (equal to the sewer service charge rate increase) and largely due to increasing debt service. Fiscal 2017 budgeted combined senior and junior lien coverage is also solid at 2.3 times and coverage of all obligations (including reimbursable general obligation bonds, state revolving fund loans and USDA bonds) down slightly to 2 times.

Coverage through 2021 of combined senior and junior lien debt service is projected to gradually decline to 1.8 times and similarly total coverage is projected to decline to 1.7 times. Including additional issuances over the next five years of between \$240 - \$370 million we believe coverage levels will decline but still remain above management's coverage policies.

The city was careful to adopt substantial rate increases in advance of substantial borrowing for its long-term capital program, enabling system revenues to keep pace with growing debt service requirements and provide satisfactory overall coverage. Moody's anticipates that the city will continue to raise rates as necessary to maintain satisfactory debt service coverage even if additional borrowing expands beyond currently planned levels to address these regulatory issues.

The city's adoption of substantial multi-year wastewater system rate increases is an important factor in the assigned ratings. After these sizable increases, wastewater rates are above average relative to the rates of other major urban systems on the mainland, although somewhat more affordable relative to household income levels. Positively, management implemented another round of multi-year rate increases of 5% in 2016 and 8% in 2017. Moody's believes that these rate actions represent important achievements in ensuring adequate bondholder security going forward.

Additionally, the city's long-term financial projections indicate that coverage levels will continue to comply with its adopted policy calling for a satisfactory 1.6 times on senior lien bonds and 1.25 times on combined senior and junior lien bonds; including reimbursable general obligation bonds and SRF loans, projected coverage of all system obligations is expected to comfortably exceed the city's target of 1.05 times coverage on all system obligations. At the Aa2 and Aa3 rating levels on the senior and junior lien bonds, respectively, Moody's believes that it will be important for the city to maintain debt service coverage levels in excess of established policy levels.

LIQUIDITY

The system's liquidity position is strong with 1,387 days cash on hand (estimated FY 2016). Officials project similar levels of liquidity over the near term before reserves decline somewhat around 2020. A relatively small portion of these reserves will be utilized for pay-go financing of capital needs.

Debt and Legal Covenants

Including the current issuance, on a pro-forma basis the system's debt ratio is somewhat elevated at 57.8% and will increase going forward as the system continues to comply with the Consent Decree. Future borrowing projections include annual issuance of between \$240 million and \$370 million through 2022, although it is likely these are conservative projections. Further, as mentioned above, over the next 15 year horizon management intends to utilize an increasing portion of net revenues to fund capital projects.

The Series 2016 transactions will not have a debt service reserve fund requirement. Prior issuances were either secured by a debt service reserve funded at 50% MADS, 100% MADS or no reserve requirement. Although a slight credit weakness, the absence of a debt service reserve requirement is mitigated by the city's established practice of segregating 50% of the following year's debt service obligation in the current year budget. Legal provisions also include covenants to maintain rates and charges sufficient to generate net revenues at least equal to 1.20 times the amount needed to pay debt service on the senior lien bonds and 1.10 times on combined senior and junior lien debt service. A similar covenant is provided for the issuance of additional parity bonds under both liens. The reimbursable general obligation bonds, as well as the debt service on the system's state revolving fund loans, are secured by a lien on net system revenues which is subordinate to the lien created by the junior lien bonds.

DEBT STRUCTURE

All of the system's debt is fixed rate.

DEBT-RELATED DERIVATIVES

The enterprise is not exposed to derivatives.

PENSIONS AND OPEB

The enterprise system's pension plan is part of the City and County of Honolulu. Honolulu has an average defined-benefit pension burden, based on unfunded liabilities for a multi-employer plan and for its Moody's-estimated share of a cost-sharing plan administered by the state. Pension costs will continue to be a pressure point for the city as contributions are budgeted to increase. The city has multiple tools available to address these increased costs, including the legal flexibility to raise property tax revenue or to trim other operating expenses. Reimbursements from the city's self-sufficient enterprises, including the wastewater enterprise totaled

\$19 million in FY 2014, a somewhat low component of the city's pension liability. Net of these reimbursements, the city's fiscal 2014 contribution was approximately \$72 million, or 7% of operating revenue.

Moody's fiscal 2014 adjusted net pension liability (ANPL) for the city, under our methodology for adjusting reported pension data, is \$2.1 billion (net of self-support), or 2.0 times operating revenues which is high for the rating category. The three-year average of Honolulu's ANPL to Operating Revenues is similar at 2.1 times, while the three-year average of ANPL to full value is average at 1.3%. Moody's ANPL reflects certain adjustments we make to improve comparability of reported pension liabilities. The adjustments are not intended to replace Honolulu's reported liability information, but to improve comparability with other rated entities.

The city's OPEB liability is sizeable and remains a challenge. As of July 1, 2013 the unfunded OPEB liability was \$1.67 billion or 1.5 times fiscal 2015 operating revenues. Notably, the wastewater enterprise makes up a small component of the city's OPEB liability.

Importantly, in the 2013 legislative session, the state adopted a plan to require phasing in higher annual required contribution (ARC) payments by all counties and the state beginning in fiscal 2015. By fiscal 2019, the payments would reach 100% of the ARC. Honolulu began setting aside amounts to pre-fund its OPEB liability beginning in 2008, and is currently ahead of the required schedule. The fiscal 2015 OPEB payment was about 76% of the ARC, compared to the state's 20% requirement.

Hawaii is the only state that has adopted a plan to fully fund its OPEB ARC payments. While the move is credit positive, it will substantially increase all local government's (including Honolulu) annual fixed costs relative to budget.

Management and Governance

Water and sewer rates are governed by the City and County Council and can be adjusted at any time during the year but generally are approved for July 1 implementation. Legal provisions are bolstered by the formal adoption of conservative debt and financial operating policies by the city council which require compliance with annual targets of 1.6 times coverage on the senior lien bonds and 1.25 times on first and second lien bonds combined. In addition, the city council resolution incorporates a favorable three-month operating and maintenance reserve fund policy which will serve to insulate the system from unexpected events.

Legal Security

The senior and junior lien bonds are secured by a first lien and second lien on the net revenues of the city's sewer enterprise.

Use of Proceeds

Proceeds will finance a portion of the system's capital improvement program and refund certain maturities of the system's previously-issued debt for annual debt service savings.

Obligor Profile

Honolulu, the capital and principal city of the State of Hawaii was incorporated in 1907 and located on the island of Oahu. The City and County of Honolulu has an area of 597 square miles and includes the entire island of Oahu. The enterprise system service area is about 82% of the island. As of 2015, Honolulu's population was estimated at 998,714.

Methodology

The principal methodology used in this rating was US Municipal Utility Revenue Debt published in December 2014. Please see the Ratings Methodologies page on www.moody's.com for a copy of this methodology.

Ratings

Exhibit 2

Honolulu (City & County of) HI Sewer Enter.

Issue	Rating
Wastewater System Revenue Bonds Junior Series 2016A (Taxable Refunding) Second Bond Resolution	Aa3
Rating Type	Underlying LT
Sale Amount	\$25,360,000
Expected Sale Date	08/17/2016

Rating Description	Revenue: Government Enterprise
Wastewater System Revenue Bonds Senior Series 2016A First Bond Resolution	Aa2
Rating Type	Underlying LT
Sale Amount	\$213,780,000
Expected Sale Date	08/17/2016
Rating Description	Revenue: Government Enterprise
Wastewater System Revenue Bonds Senior Series 2016B (Refunding) First Bond Resolution	Aa2
Rating Type	Underlying LT
Sale Amount	\$168,385,000
Expected Sale Date	08/17/2016
Rating Description	Revenue: Government Enterprise
Wastewater System Revenue Bonds Senior Series 2016C (Taxable Refunding) First Bond Resolution	Aa2
Rating Type	Underlying LT
Sale Amount	\$13,855,000
Expected Sale Date	08/17/2016
Rating Description	Revenue: Government Enterprise

Source: Moody's Investors Service

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